In the Supreme Court of the United States

OCTOBER TERM, 1928.

No. 481

ROBERT H. LUCAS, COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF KENTUCKY, PETITIONER

v.

A. J. ALEXANDER.

BRIEF FOR RESPONDENT

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v.

A. J. A. ALEXANDER.

BRIEF FOR RESPONDENT

The petitioner bases his right to the writ on the following grounds: First, that the Circuit Court of Appeals decided an important question in Federal taxation which has not been heretofore decided by this court; second, that the Circuit Court did not apply Section 213-B of the Revenue Act of 1918 to the case under consideration, when in fact it was applicable; third, that the decision of the Circuit Court of Appeals is in conflict with the *Penn Mutual Life Insurance Company* vs. *Lederer*, 252 U. S. 523; *New York Life Insurance Company* vs. *Edwards*, 271 U. S. 109; fourth, that the decision of the Circuit Court of Appeals is in conflict with the rulings of the Board of Tax Appeals in the appeals of E. A. Armstrong, 1 B. T. A. 296; Appeal of Cline, 3 B. T. A. 1138; *Chamansky* vs. *Commissioner*, 8 B. T. A. 1276; fifth that the case is of great public interest and importance to the government in the administration of the Revenue laws.

(Page 6 of Petition).

(1) The respondent in 1899 was insured in the New York Life Insurance Company, a mutual company, doing business on the level premium plan, under two policies, identical in terms, of the face value of $50,000.00 each.

(R. 16-30).

The premium on the policies aggregated $7,810.00 annually and were to be paid for a period of ten years at which time the policies became fully paid up. The premiums were paid and on March 19, 1908, the respondent had paid all that he would ever be called upon to pay under the contracts. At the end of the twentieth year, the policies matured and the petitioner had various options to be exercised under the terms of the contract. On May 19, 1919, at maturity, the respondent elected to accept the benefits of Option 4 (R. 30), and received the entire cash value which was $120,797.00.

(R. 55).

The insurance contracts had no cash surrender value but did have certain loan values all of which are set out on page 29 of the Record. The petitioner, in making his income tax return for the taxable year 1919, reported a profit growing out of the surrender of the policies of $17,290.35 (R. 9). The Commissioner of Internal Revenue reaudited his tax return and found the profit on the surrender of the policies to be $42,697.00 which was the difference between the total amount received, to wit, $120,797.00 and $78,100.00, the sum paid in premiums.

(R. 55).

The respondent paid additional taxes found to be due by the Commissioner and, after complying with the formal provisions of the refunding statutes, instituted suit to recover the taxes thus paid. Judge Dawson of the district court at Louisville, in finding the March 1, 1913, value of the policies, said:

> "Under all the circumstances, I think it is fair to both the Government and the plaintiff to fix the value of what the plaintiff could at that date have reasonably anticipated they would have been worth on the 19th day of May, 1919, under the fourth option heretofore referred to, arriving at the then present value by the application of a four per cent interest rate, compounded annually. As I have heretofore indicated, I think the plaintiff on March 1, 1913,

> could reasonably have anticipated that at the end of the accumulation period he would receive at least $19,428.57 of accumulations, and in addition thereto the face value of the policies, or a total of $119,-428.57. The present value of this sum on March 1, 1913, at four per cent interest, compounded annually would be $93,587.81. This amount, I think, should be treated as the fair value of the plaintiff's two policy contracts on March 1, 1913. Deducting this sum from $120,797.00, the amount actually received by the plaintiff upon surrender of his policies at the end of the accumulation period, would result in a taxable gain of $27,209.19. Of this sum $20,797.00 was paid out of earned surplus, and is therefore taxable as dividends, which $6,412.19 thereof would be subject to both normal and surtax."
>
> (R. 43-44).

The Circuit Court of Appeals for the Sixth Circuit affirmed the judgment of Judge Dawson.

The Court of Appeals of Kentucky, in the case of the *Equitable Life Assurance Society* vs. *Winn*, 137 Ky. 649; 126 S. W. 153; 28 L. R. A. 558, in discussing the relationship existing between an insurance company and a policy holder, under the contracts similar to that of the respondent, said:

> "The insurer undertakes to handle the fund for the parties. Its pay is in the costs and expenses which it charges as toll. The balance not only belongs equitably to those contributing to it, according to the terms of their contracts, but the insurance company agrees to so apportion it among them. Now, why should it not keep its contract? To keep it faithfully, and honestly, it is required to keep books of account. Otherwise its apportionment would be a mere guess, even if it rose to that dignity. It is a trustee, an agent of those for whom it has essayed to act. It will not be heard to say that it would be too troublesome to keep the accounts, or would cost

too much to render the parties a true statement, or on that account be impracticable to show to a court of chancery in a suit for accounting the state of the books."

The case does not present an important question of Federal taxation not heretofore decided by the courts. The sole question is valuing contracts March 1, 1913, and similar questions have often been before the Courts and the Board of Tax Appeals. However, the specific question of valuing an insurance policy has not been decided.

Insurance contracts have all the elements of other contracts and stand on the same footing. It is true that such contracts cannot be traded in because of the lack of insurable interest but the respondent owned the two policies March 1, 1913, and there was a reasonable expectation that he would live to maturity of the contracts in 1919. It was as easy to value these contracts March 1, 1913, as it was the contract in the case of *Kentucky Tobacco Products Company* vs *Lucas*, 5 Fed (2d) 723 which the Court did.

To adopt the valuation made by the Commissioner of Internal Revenue works a hardship and a discrimination to taxpayers receiving the face of insurance policies where all the premiums were paid prior to March 1, 1913. The respondent had paid all the premiums on the policies in 1909 five years before the income tax law became effective and to decide that there was no increase in the value of the policies before March 1, 1913, is manifestly contrary to all the fundamental principles of life insurance. Such a contract gradually appreciates in value to the insured. The sum available for distribution on maturity increases as the life lengthens.

The respondent could reasonably expect on March 1, 1913, a return of $120,000.00 at maturity based on the known facts March 1, 1913.

(2) The point is urged that the Circuit Court did not apply or construe section 213 (b) (2), Revenue Act of 1918, c. 18, 40 Stat. 1057, 1065. This is not true. Section 213 is

set out in full on page 3 of the printed copy of the Circuit Court's Opinion and it applies and construes that section in reaching its conclusion as the March 1, 1913, value of the policy.

No matter what the language of the Revenue Act under consideration may be it can have no application to a gain which had become capital March 1, 1913, *Doyle* vs. *Mitchell Bros.*, 247 U. S. 179.

Subsection 2 of the Revenue Act of 1918 does provide:

> "The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract."

This section of the Statute must be construed together with Subsection 1 of Section 202 which provides,

> "In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date."

Under the very language of the law, the only gain taxable is the accruing income after March, 1913. This was fully considered by the Circuit Court.

(3) The decision of the Circuit Court of Appeals is not in conflict with *Penn Mutual Life Insurance* vs. *Lederer*, 252 U. S. 523, and *New York Life Insurance Co.*, vs. *Edwards*, 271 U. S. 109.

These two cases involve the tax liability of the insurance companies and not the value of the policies of the insured. Both companies sought to deduct from income dividends provisionally ascertained but not paid or allocated to the particular policies. The Court decided this could not be done.

The respondent did not have a fixed liability against the insurance company on March 1, 1913, but he did have an insurance contract susceptible to a fair money value and he could, with reasonable expectation, determine what the policies would produce in 1919 at maturity. It will thus be seen that the two cited cases have no application to the case under consideration.

(4) The decision of the Circuit Court of Appeals is not contrary to the rulings of the United States Board of Tax Appeals in the Appeal of E. A. Armstrong, 1 B. T. A. 296; Appeal of Kline, 3 B. T. A. 1138; and *Chamansky* vs. *Commissioner*, 8 B. T. A. 1276.

In the Armstrong case the taxpayer had in 1901 taken out a policy in the Union Central Life Insurance Company for $10,000.00 face value with annual premiums of $478.40 for fifteen years. The policy had certain tontine features which were not disclosed in the statement of facts. The policy had no maturity date and it was impossible for the taxpayer to determine March 1, 1913, that he would realize anything from it at all. Its surplus accumulation depended, not on earnings of the company, but on lapses or death of members of the group. It has no similarity to the case here.

The appeal of Kline, 3 B. T. A. 1138, is distinguished from the case at bar in the opinion of the Circuit Court and has no question similar to this one.

In the case of *Chamansky* vs. *Commissioner*, 8 B. T. A. 1276, the question was whether the sum received on settlement of the policy was taxable as dividends or as ordinary income. There is no similarity between it and the case here.

(5) The point is seriously urged that this case is one of great public interest and importance to the Government. We earnestly contend that this is not true. As heretofore pointed out, it is a simple question involving the market value of a contract and if it is of importance, a casual exami-

nation of the record clearly indicates that the decision of the Circuit Court is correct.

Conclusion

We respectfully submit that the petition for the writ of *certiorari* to review the judgment of the Circuit Court of Appeals, Sixth Circuit, should be denied.

Beckham, Hamilton & Beckham,

George V. Triplett, Jr.,

Attorneys for Respondent.

FILED
FEB 25 19
CHARLES ELMORE C

IN THE

Supreme Court of the United States

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No. 481.

ROBERT H. LUCAS, Collector of Internal Revenue for the District of Kentucky, - - - - - Petitioner,

vs.

A. J. A. ALEXANDER, - - - - - - Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

BRIEF FOR RESPONDENT.

ELWOOD HAMILTON,
Attorney for Respondent.

GEORGE V. TRIPLETT,
BECKHAM, HAMILTON & BECKHAM,
Of Counsel.

WESTERFIELD-GOETZ COMPANY, INCORPORATED, LOUISVILLE, KY.

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

BRIEF FOR RESPONDENT.

I.

STATEMENT OF CASE.

The above case comes to this Court on petition for *certiorari* to the United States Circuit Court of Appeals for the Sixth Circuit. The petition was filed September 28, 1928, and granted November 19, 1928 (R., p. 75).

The opinion of the lower court is found in the case of Lucas v. Alexander, Nos. 4973, 4974, and reported in 27 Fed. (2d) 237, and in the record, pages 70 to 74.

The action was filed in the District Court at Louisville, Kentucky, by A. J. A. Alexander, the respondent, against the petitioner, Robert H. Lucas, Collector of Internal Revenue for the District of Kentucky, seeking to recover income taxes, which the respondent claims were erroneously collected from him by the petitioner for the calendar year 1919 in the sum of $8,750.91 (R., p. 27).

The case was tried by Judge Chas. I. Dawson, District Judge for the Western District of Kentucky, on the law and facts, a jury being expressly waived (R., pp. 33-38). Judge Dawson rendered a written opinion in the case on March 9, 1927 (R., p. 28), and on the same date separated the findings of law and fact and a judgment was entered for the respondent in the sum of $6,519.36, together with interest and cost (R., p. 33).

The petitioner appealed by writ of error from the decision of the District Court to the United States Circuit Court of Appeals for the Sixth Circuit, which Court affirmed the judgment of the District Court June 30, 1928 (R., p. 70).

II.

STATEMENT OF FACTS.

The lower Court found the facts to be as follows:

> "First. Plaintiff is a citizen of Kentucky and resides at Spring Station, in the eastern district of Kentucky.
>
> "Second. Defendant is a resident of Louisville, Kentucky and since the 24th day of May, 1921, has

been the duly appointed, acting, and qualified collector of internal revenue for the district of Kentucky.

"Third. Plaintiff, before March 15, 1920, duly filed with the then collector of internal revenue for the district of Kentucky his income tax return for the calendar year 1919 and showed thereon, among things as income, dividends on insurance policies in the sum of $17,290.35, and a total net income of $65,690.21, and thereafter duly paid voluntarily and without protest to the then collector of internal revenue taxes assessed thereon in the sum of $13,135.52.

"Fourth. Plaintiff, on the 5th day of June, 1899, upon his application, was granted by the New York Life Insurance Company of New York City, New York, effective May 19, 1899, two policies of life insurance, each in the sum of $50,000.00 and each on the face thereof described as 'insurance bond with guaranteed interest.' Plaintiff agreed to pay on each policy in advance premiums at the rate of $3,905.00 per annum for a period of ten years, and his premium payments on said policies in the total sum of $78,100.00 were completed on March 19, 1908.

"Said New York Life Insurance Company is a mutual life insurance company doing business on the mutual-level premium plan.

"Fifth. Each of said policies contained the following provisions as to deferred dividends and surplus:

"'ACCUMULATION GUARANTEES.

"'This insurance bond participates in surplus as hereinafter provided, but no dividends shall be

apportioned to it before the end of the accumulation period. If the insured elects to continue this insurance bond beyond the accumulation period under one of the two accumulation benefits first named below, no further dividend shall be apportioned to it before the end of each period of five years thereafter.

"'The accumulation period of this insurance bond ends on the nineteenth day of May in the year nineteen hundred and nineteen. If the insured is living and if the premiums have been duly paid to that date, and not otherwise, the company will then apportion a dividend to the insured, who shall have the option of continuing or discontinuing this insurance bond under one of the following four accumulation benefits:

"'(1) Receive an income of two thousand dollars and ——— cents per annum during life (being equal to four percent of the initial amount of the insurance, $50,000), the first payment to be made on the nineteenth day of May, nineteen hundred and twenty, and receive the dividend converted into a life annuity payable with the income as above, and continue this insurance bond without further payment of premiums (evidence of good health will not be required); or,

"'(2) Receive the dividend, in cash, and receive an income for life, payable as specified in the "first benefit," and continue this insurance bond without further payment of premiums (evidence of good health will not be required); or,

"'(3) Receive the entire cash value, as stated below, converted into an annual income during the life of the insured, payable as provided in the "first benefit" which income the company guarantees

shall be not less than thirty-four hundred and seventy-four dollars and ——— cents, and discontinue this insurance bond; or,

" '(4) Receive the entire cash value, as stated below, in cash, and discontinue this insurance bond.

" 'The company guarantees that the entire cash value of this insurance bond at the end of the accumulation period shall be fifty thousand dollars, and in addition the cash dividend then apportioned by the company.

" 'At the end of the accumulation period the company will send the insured a written statement, setting forth the results under each of the above accumulation benefits, and if the insured shall fail at that time to notify the company which benefit has been selected, the first benefit shall be considered selected.'

"Sixth. Each of said policies matured on the 19th day of May, 1919, and plaintiff elected to receive from the company, in accordance with the provisions of said option #4, the cash surrender value thereof, to-wit, $120,797.00, and subsequently said company on the surrender to it of said policies of insurance paid to said plaintiff in the calendar year 1919 cash to the amount of said $120,797.00.

"Seventh. On reaudit of plaintiff's income-tax return for said calendar year 1919 the Commissioner of Internal Revenue determined and found the amount of income realized by plaintiff on the surrender of his said policies to be the sum of $42,697.00 or the difference between the cash surrender value thereof, $120,797.00, and the total premiums paid by plaintiff, $78,100.00, and after making certain adjustments not material here duly assessed

an additional tax for said calendar year 1919 of $11,334.17 against said plaintiff.

"Eighth. Plaintiff, prior to bringing this action against the defendant on May 27th, had not paid the amount of said additional taxes assessed against him by said Commissioner of Internal Revenue, but had paid to said defendant only a portion thereof, to wit, the sum of $8,750.91, as follows:

"On November 2, 1923, plaintiff paid to defendant the sum of $8,013.54 under written protest and later, on December 5, 1923, the further sum of $737.37, making a total payment by said plaintiff to said defendant of said sum of $8,750.91, and no more, on said additional assessment of $11,-334.17.

"Ninth. Plaintiff, on December 5, 1923, filed with defendant certain claims for credit for alleged overpayment of income taxes for the calendar years 1918, 1920, 1921 and 1922, in the sums of $1,072.41, $434.97, $424.21, and $651.67, respectively, claiming total credits on account thereof in the sum of $2,583.26 as against said additional assessment of $11,334.17 for said calendar year 1919, and that said credit claims were duly transmitted to the collector of internal revenue, but no action thereon has been as yet taken by said Commissioner of Internal Revenue.

"Tenth. Subsequent to the assessment of said additional tax of $11,334.17 against said plaintiff by said Commissioner of Internal Revenue, said plaintiff filed with this defendant a purported claim in abatement and claim for refund in the sums of $3,320.63 and $4,894.39, respectively, to which was attached an amended return executed

by said plaintiff for said calendar year 1919, which showed, among other things, 'income from insurance policy' of $21,900.00, a total net taxable income of $70,621.39, and a total tax, according to plaintiff's computation of $16,132.20.

"Eleventh. Said purported claim for abatement and claim for refund was not transmitted by the defendant to the Commissioner of Internal Revenue at Washington, D. C., but said defendant notified said plaintiff by letter dated October 31, 1923, as follows:

"October 31, 1923.

JJB/ES
IT-2
Mr. A. J. A. Alexander,

Care Beckham, Hamilton & Beckham,
Inter-Southern Building, Louisville, Kentucky.

"Sir: This office is in receipt of your letter of the 26th instant enclosing check for $8,013.54 to apply on assessment of additional income tax for the year 1919; also a claim in abatement for $3,320.63 covering the remainder of the assessment.

"I regret to advise that this additional assessment is made by the Commissioner of Internal Revenue in accordance with section 250 (d) of the revenue act of 1921, which prohibits the collector from accepting a claim in abatement. It is therefore necessary to ask that payment of the full amount of $11,334.17 be made, and after the full payment is received the claim will be allowed to operate as a refund claim. Under the law there is no other course for this office to pursue, and I trust

that you will forward remittance for $3,320.63 by return mail.

Respectfully,

Robt. H. Lucas, Collector.

By Chief, Income Tax Division.

"Twelfth. After plaintiff filed said credit claims for said years 1918, 1920, 1921 and 1922, referred to in paragraph ninth hereof, plaintiff, on March 13, 1924, filed with this defendant's claim for refund in the sum of $18,755.87, which defendant duly transmitted to the Commissioner of Internal Revenue at Washington, D. C., but said Commissioner of Internal Revenue had taken no action thereon on or prior to May 27, 1924.

"Thirteenth. Said plaintiff, in filing his original return for said calendar year 1919, had failed to claim a deduction for depreciation on certain real estate in which he had an interest in the city of Chicago; and said Commissioner of Internal Revenue, on consideration of plaintiff's claim for refund of March 13, 1924, allowed a portion of the depreciation, and on October —, 1925, on account thereof, duly issued to said plaintiff a certificate of overassessment for said calendar year 1919 in the sum of $2,319.99.

"Fourteenth. That the correct income of the plaintiff for the year 1919 is as follows:

Gross income:		
Income from farming		$61,216.48
Deductions:		
Labor	$7,195.42	
Material supplies	12,154.87	
Merchandise bought for resale	32,972.40	
General expense	2,075.75	
Inventory beginning of year	36,980.00	
	$91,378.44	
Less inventory at end of year	59,365.00	
	$32,013.44	
Other deductions:		
Salaries	$3,612.78	
Rent	24.00	
Interest	780.67	
Taxes	1,860.00	
Repairs	656.50	
		$38,947.39
		$22,269.09
Other income:		
Salaries		2,000.00
Income from rent	$45,842.51	
Deductions:		
Repairs, wear and tear	$2,417.95	
Interest	4,583.33	
Taxes	4,543.15	
Other expenses	7,312.41	18,856.84
Income from rents		26,985.67
Trust income		5,200.00
Income from insurance policies		6,412.19

Dividends on insurance policies		20,797.00
Interest on bonds, foreign country		163.79
Ordinary dividends		4,337.11
		$88,164.85
Other deductions:		
Interest	$1,065.00	
Taxes paid	237.67	
Contributions	13,029.32	
		14,331.99
		$73,832.26

"Fifteenth. That the income tax to be determined on the above income is as follows:

Net income		$73,832.86	
Deductions:			
Dividends	$25,134.11		
Exemptions	1,400.00		
		26,534.11	
		$47,298.75	
Taxable at 4%		4,000.00	$160.00
Taxable at 8%		$43,289.75	3,463.90
Surtax			11,743.17
Total tax			$15,367.07

"Sixteenth. That the plaintiff paid to the collector of internal revenue on income shown on his original return, taxes in the following amounts:

Feb. 28, 1920	$3,283.88	
June 14, 1920	3,283.88	
Sept. 15, 1920	3,283.88	
Dec. 4, 1920	3,283.88	
		$13,135.52

"Seventeenth. That the plaintiff paid to the Collector of Internal Revenue on an additional assessment of taxes for 1919 in the amount of $11,334.17 the following amounts:

Nov. 2, 1923	$8,013.54	
Dec. 5, 1923	737.37	
		$8,750.91

"Eighteenth. That the defendant, Robert H. Lucas, collector of internal revenue for the district of Kentucky, erroneously collected from the plaintiff, on Nov. 2, 1923, but with probable cause $6,519.36, income taxes for the calendar year 1919.

"Nineteenth. That the court finds the March 1, 1913, value of the two insurance policies to be $93,587.81, which sum deducted from the amount received by the plaintiff on the surrender of the policy, to wit, $127,797.00, leaves a taxable gain of $27,209.19. Of this sum, $20,797.00 was paid out of earned surplus, and therefore taxable as dividends, and the balance of $6,412.19 subject to both normal and surtax" (R., pp. 34-38).

III.

QUESTIONS FOR DECISION.

What taxable gain, if any, was realized by the respondent under the provisions of Sections 213 (b) (2) and 202 (a) (2) of the Revenue Act of 1918, upon surrender by him, at maturity, May 19, 1919, of two participating, deferred dividend policies issued to him on May 19, 1899?

IV.

THE LAW.

THE CONSTITUTION:
Sixteenth Amendment:

"The Congress shall have power to lay and collect taxes on income from whatever source derived without apportionment."

THE STATUTES:
Section 202 of the Revenue Act of 1918:

"(a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal or mixed, the basis shall be—

"(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

"(2) In the case of property acquired on or after that date, (a) the cost thereof; or (b) the inventory value, if the inventory is made in accordance with section 203. * * *" (40 Stat. L. 1060).

Section 213 of the Revenue Act of 1918:

"Gross income defined. That for the purposes of this title (except as otherwise provided in section 233) the term 'gross income'—

"(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States and

all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; but

"(b) Does not include the following items, which shall be exempt from taxation under this title:

"(1) The proceeds of life insurance policies paid upon the death of the insured to individual beneficiaries or to the estate of the insured;

"(2) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the terms or at the maturity of the term mentioned in the contract or upon surrender of the contract; * * *" (40 Stat. L. 1065).

Section 210 of the Revenue Act of 1918:

"That in lieu of the taxes imposed by subdivision (a) of Section 1 of the Revenue Act of 1916,

and by Section 1 of Revenue Act of 1917, there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax, at the following rates:

"(a) For the calendar year 1918, 12 percentum of the amount of the net income in excess of the credits provided in section 216; provided, that in the case of a citizen or a resident of the United States the rate upon the first $4,000.00 of such excess amount shall be 6 percentum;

"(b) For each calendar year thereafter, 8 percentum of the amount of the net income in excess of the credits provided in Section 216; provided that in the case of a citizen or resident of the United States the rate upon the first $4,000.00 of such excess amount shall be 4 percentum."

THE REGULATIONS:
Articles 71 and 72 of Regulations 45:

"What excluded from gross income.—Gross income excludes the items of income specifically exempted by the statute and also certain other kinds of income by statute or fundamental law free from tax. Such tax-free income should not be included in the return of income and need not be mentioned in the return, unless information regarding it is specifically called for, as in the case, for example, of interest on municipal bonds. See article 402. The exclusion of such income should not be confused with the reduction of taxable income by the application of allowable deductions. See section 212 of the statute and article 21. As to exclusions from gross income by corporations, see section 233 and article 541.

"Proceeds of insurance.—(a) Upon the death of an insured the proceeds of his life insurance policies, whether paid to his estate or to individual beneficiaries (including partnerships), directly or in trust, are excluded from the gross income of the beneficiary. See article 541.

"(b) During his life only so much of the amount received by an insured under life, endowment or annuity contracts as represents a return, without interest, or premiums paid by him therefor is excluded from his gross income. See article 47.

"(c) Whether he be alive or dead, the amounts received by an insured or his estate or other beneficiaries through accident or health insurance or under workmen's compensation acts as compensation for personal injuries or sickness are excluded from the gross income of the insured, his estate and other beneficiaries. Any damages recovered by suit or agreement on account of such injuries or sickness are similarly excluded from the gross income of the individual injured or sick, if living, or of his estate or other beneficiaries entitled to receive such damages, if dead. See further article 294. Since June 25, 1918, no assessment of any Federal tax may be made on any allotments, family allowances, compensations, or death or disability insurance payable under the War Risk Insurance Act of September 2, 1917, as amended, even though the benefit accrued before that date."

V.

QUESTIONS AT ISSUE.

First: Are the proceeds of an insurance policy received by an insured where all premiums are paid prior to March 1, 1913, taxable income?

Second: What was the March 1, 1913, value of the two insurance policies of the respondent cashed by him for $120,797.00 in 1919?

VI.

ARGUMENT AND BRIEF.

Plaintiff realized no taxable gain on the surrender by him in 1919 of the two insurance policies, because all premiums due on said policies were paid before 1909 and the sum realized by him grew out of a contract based on the length of a human life and was not susceptible to measurement in money and is not income under the Sixteenth Amendment.

Point I. Proceeds of Life Insurance Policies do not Constitute Income Under the Sixteenth Amendment.

The Sixteenth Amendment authorized the Congress to tax only income. Income does not mean the mere receipt of money. There must have been some accretion after March 1, 1913. Receipt of the proceeds of an insurance policy does not ordinarily result in gain as understood under the definition of "income."

The proceeds replace a loss occurring by reason of lapse of time but do not add to the wealth of the insured. If collected in his lifetime, the sum received cannot be used to replace the loss by the acquisition of similar property. Time has exacted its toll. The increased premium necessary to replace the insurance exceeds the apparent gain over premiums paid and sum received.

The Brittanica, under the heading "Insurance," in discussing its value, says:

> "The value of insurance cannot be measured by figures. No direct balance sheet of profit or loss can exhibit its utility. The insurance contract produces no wealth. It represents only expenditures. If a thousand men insure themselves against any contingency, then whether or not the dreaded event occurs to any, they will in the aggregate be poorer as the direct result by the exact cost of the machinery for effecting it.
>
> "The distribution of property is changed, its sum is not increased, but the results in the social economy, the substitute of reasonable foresight and confidence for apprehension and sense of hazard, the large elimination of chance from business and conduct have a supreme value. The direct contribution of insurance to civilization is made not in visible wealth, but in the intangible and immeasurable forces of character on which civilization itself is founded. It has done more than all gifts of impulsive charity, to foster a sense of human brotherhood and of common interest. It has done more than all repressive legislation to destroy the gambling spirit. It is impossible to conceive of our

> civilization in its full vigor and progressive power without insurance. This principle which unites the fundamental law of practical economy that he best serves humanity who best serves himself, with the golden rule of religion 'Bear ye one another's burdens.' "

The respondent received the policies May 19, 1899, and on May 19, 1908, he had paid $78,100.00, or his total premiums.

There is no presumption arising by inference or otherwise that all or any of the gain between premiums paid and the sum received was realized in 1919. Section 210 of the Revenue Act of 1918 provides for annual rest in determining taxable profit and all that can be taxed in any annual period is that realized in that period. If all or any part of the cash received was earned before March 1, 1913, that portion attributable to or prior to March 1, 1913, is not income.

The Act of March 2, 1867 (14 Stat. at L., pp. 477, 478, Sec. 13) provided for gains and profits for the year ending December 31st which is in substance the same provision as Section 210 of the Revenue Act of 1918. In the case of Gray, Collector, v. Darlington, 14 Wall. 63, 82 U. S. 68, 21 Law Edition, 46, Darlington sold Government bonds which he had owned over a period of years. The Commissioner sought to tax all the gain in the year of payment. In holding that the Commissioner was in error, this Court said:

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the

amount of the advance. Mere advance in value in no sense constitutes the gains, profits or income specified by the statute. It constitutes and can be treated merely as increase of capital.

"The rule adopted by the officers of the revenue in the present case would justify them in treating as gains of one year the increase in the value of property extending through any number of years, through even the entire century. The actual advance in value of property over its cost may, in fact, reach its height years before its sale; the value of the property may, in truth, be less at the time of the sale than at any previous period in ten years, yet, if the amount received exceed the actual cost of the property, the excess is to be treated, according to their views, as gains of the owner for the year in which the sale takes place. We are satisfied that no such result was intended by the Statute."

In the case of the United States Life Insurance Company v. Spinks, 126 Ky. 417, the Court of Appeals of Kentucky, in describing life insurance, said:

"Life insurance is not a modern business invention although modernly many new features have been added to it, which may seem to be foreign to its original conception. But the main principle upon which it rests has not been changed. The plan is to collect from a class of selected persons, chosen with reference to their ages, health, occupations, and so forth, such a fixed sum as will, when kept safely invested at interest, pay to the estate of each of them when he dies, a certain sum of money, which was originally taken as the basis of

the collections. It has been found, and it is a fact that this can be done. The percentage of mortality of such persons is ascertainable in advance. From a long series of observations it is known to a reasonable certainty how many of the number will die within a given time. Thus the life tables, or tables of mortality, have been made up. The one in most common, if not universal use in this country, is the American Experience. From these it is shown that of a given number of such persons of the same age and condition, each contributes a certain sum, either in one lump sum in advance, or in annual installments, that such contribution when loaned or invested at current interest compounded will so increase that as each one of the contributing class dies there will be enough in the common fund to pay to his estate a principal sum previously taken as the basis of the charges which he has contributed. The sum which he is required to pay is called the premium. If 1,000 men, aged 20, enter into an agreement to pay each one as he dies $1, and to provide in advance a fund therefor, which will be sufficient, and no more than sufficient, to meet the undertaking, they find that from the tables of mortality so many will die the first year, so many the second year, and so on, so that enough will have to be paid in advance that out of it there can be paid the death claims of the per cent who will die each year, and leave enough which, placed at compound interest, will accumulate a fund sufficient to pay all the others as they die the agreed sum of $1."

In the case of the United States v. Supplee-Biddle Hardware Company, 265 U. S. 189, 4 A. F. T. R. 3990, the Supreme Court was asked to decide that the pro-

ceeds of life insurance paid on the death of a person was in fact capital and not income. It declined to pass on the question, but did say:

> "It is earnestly pressed upon us that proceeds of life insurance paid on the death of the insured are in fact capital and cannot be taxed as income under the Sixteenth Amendment. Eisner v. Macomber, 252 U. S. 189, 207, 40 Sup. Ct. 189, 64 L. Ed. 521, 9 A. L. R. 20 R. 1570; Merchants' Loan & Trust Co. v. Smietanka, 255 U. S. 509, 518, 41 Sup. Ct. 386, 65 L. Ed. 751, 15 A. L. R. 1305. We are not required to meet this question. It is enough to sustain our construction of the act to say that proceeds of a life insurance policy paid on the death of the insured are not usually classed as income."

Life insurance is not a commercial commodity. It is not dealt in on any stock exchange or traded in any market. It cannot pass freely between buyer and seller. Those who may contract concerning it are so limited in number it could never have a market value.

Under the laws of Kentucky one must have an insurable interest in another before he can acquire by purchase an interest in the insurance on his life.

The Court of Appeals of Kentucky in the case of Hess, Administrator, versus Segenfelter, 127 Ky. 348; 105 S. W. 476, in discussing the necessity of insurable interest before insurance could be collected, said:

> "On the other hand, what is known as 'wagering or gambling insurance' is universally con-

demned, and our court, in harmony with the doctrine generally prevailing, is strongly committed to the principle that a person cannot himself procure insurance upon a life in which he has not an insurable interest, growing out of a kinship, dependency, or the relation of debtor and creditor, nor obtain an assignment of such insurance; nor will a person be permitted to insure his own life for the benefit of another, if that other induces him to procure the insurance and pays the premiums thereon, or there is any evidence tending to show that the insurance was obtained with a view to avoid or evade the law against speculative insurance. Griffin's Adm'r v. Equitable Assurance Society, 84 S. W. 1164, 27 Ky. Law Rep. 313; Bromley v. Washington Life Ins. Co., 92 S. W. 17, 28 Ky Law Rep. 1300, 5 L. R. A. (N. S.) 747; Beard v. Sharp, 100 Ky. 606, 38 S. W. 1057, 18 Ky. L. R. 1029; New York Life Ins. Co. v. Brown, 66 S. W. 613, 23 Ky. Law Rep. 2070; Baldwin v. Haydon, 70 S. W. 300, 24 Ky. Law Rep. 900; Wrather v. Stacey, 82 S. W. 420, 26 Ky. Law Rep. 683; Lee v. Mutual Life Insurance Company, 82 S. W. 258, 26 Law Rep. 577; Barbour v. Larue, 106 Ky. 546, 51 S. W. 5, 21 Ky. L. R. 94; Basye v. Adams, 81 Ky. 363, 5 Ky. L. R. 91; Lockett v. Lockett, 80 S. W. 1152, 26 Ky. Law Rep. 300; Scott v. Scott, 77 S. W. 1122, 25 Ky. Law Rep. 1356; Adams v. Reed, 38 S. W. 420, 18 Ky. Law Rep. 853, 35 L. R. A. 692; Bramblet v. Hargis, 94 S. W. 20, 29 Ky. Law Rep. 610. Such insurance has a tendency to create a desire to destroy the life of the insured to obtain the insurance, there being no tie of blood or kindred, or interest to wish its prolongation; and a person who procures for his benefit insurance upon the life of

another, when he is not connected with that life by ties of kindred or dependency, or interested in its continuance from business motives, may be actuated solely by a purpose to derive profit from its destruction, and be rewarded by wagering against the amount payable at his death the sums expected in premiums during his life."

The number who can be beneficially interested in a life insurance policy is so limited that it can scarcely be said to be income gained through the sale or conversion of capital assets, if cashed.

The benefits accruing always rest basically on a human life and independently can have no existence. The contributions to procure and the sums received for it are so personal in nature that whatever is received does not fall within the definition of "income" as used in the Sixteenth Amendment. It is uniformly held that compensation for personal injuries, alimony payments and similar items are not taxable income. Such personal rights are not susceptible of money appraisal. See Gould v. Gould, 245 U. S. 151 (an alimony case).

There is no provision in the Revenue Act of 1918 relating particularly to the profit arising from an insurance policy and if taxable at all, it must be under the general provisions of the law. None of the items referred to in Section 213 of the Revenue Act of 1918 (40 Stat. 1065), refer specifically to the proceeds of a life insurance policy. The conversion to cash of life insurance policies is always contingent on the occurrence of two events, either the insured living to a fixed period or dying sooner. No income can arise from it

as enumerated in the law. It deals with none of those things but only with human life. Because perchance, the insured lives to a fixed time and cashes in his policy does not change the fundamentals of the contract. It is a replacement, a substitute for something lost.

Point II. The Insurance Policies of the Respondent were Contracts Primarily for Protection and not Investment.

It has been sometimes urged that insurance policies similar to those cashed by the respondent are contracts of hazard and therefore void. In the case of Simmons v. New York Life Insurance Company, 45 N. Y. Supreme Court Reports, 38 Hun. 316, the Court construed a policy essentially the same as that of respondent's and decided it was not a gambling contract. The Court of Appeals of Illinois, in the case of Rothchild v. New York Life Insurance Company, 97 Ill. App. Ct. 556, also held that similar policies of the New York Life Insurance Company were not gaming contracts. While these policies had hazards common to all life insurance contracts, they were out of the field of chance and provided protection which is the primary purpose of all life insurance.

The policies issued to the respondent (R., p. 12), provided for the payment of $50,000.00 on each of them to the personal representative of the insured in case of his death during the first ten years of their existence. This sum was gradually increased each year and during

the life of the policies, according to the terms of each, the following sums were payable in case of death:

"Table of Amounts payable in event of death during the accumulation period. If premiums are paid in full to date of death.

"The amount payable to the insured, in event of death prior to May 19, 1919, as specified on the face of the Bond, will be as set forth in the following table:

Year	Amount Payable		
First to tenth, inclusive	$50,000.00		
Eleventh	$50,700	Sixteenth	$61,650
Twelfth	52,700	Seventeenth	64,150
Thirteenth	54,800	Eighteenth	66,700
Fourteenth	57,000	Nineteenth	69,350
Fifteenth	59,300	Twentieth	72,150

If death occurred during the twentieth year it will be noted from the above schedule that the estate of the decedent would have received $144,300.00. The policies had no surrender value but did have the following loan and paid up insurance provisions (R., p. 16):

At End of		Paid up Loans Insurance	Extended Insurance for $50,000 for the term specified below, with cash, if then living.							
3rd	Year	7,950	$15,000	17	Years	0	Months	with	$4,100	Cash
4th	"	10,600	20,000	16	"	0	"	"	11,700	"
5th	"	13,500	25,000	15	"	0	"	"	19,300	"
6th	"	16,750	30,000	14	"	0	"	"	25,250	"
7th	"	20,350	35,000	13	"	0	"	"	31,050	"
8th	"	24,350	40,000	12	"	0	"	"	36,500	"
9th	"	28,600	45,000	11	"	0	"	"	41,850	"
10th	"	30,600								
11th	"	32,700								
12th	"	34,900								
13th	"	37,300								
14th	"	39,700								
15th	"	42,250								
16th	"	44,950								
17th	"	46,500								
18th	"	48,150								
19th	"	49,900								
20th	"	For special Advantages at end of Accumulation Period, See Accumulation Benefits Below.								

The policies did have accumulation guarantees subdivided into four accumulation benefits (R., p. 16), but these were only incidental to the main provisions of the policies which was indemnity to the respondent's estate for the loss of his life.

The New York Life Insurance Company was a Mutual company. Its savings were in excess interest earnings, savings on mortality and expense loadings. The premiums charged were based on the life expectancy of the person insured with such a rate of interest compounded thereon semi-annually as would create a sum at the end of the life sufficient to pay the face of the policy. The whole scheme was based on the life expectancy of every member insured in the Company.

The policies of the respondent provided for payment in the case of death in the year of the end of the accumulation period of $23,503.00 more than was paid on the surrender of the policies. This large discount clearly indicates that the two policies were not primarily for investment but were to protect respondent's estate against loss by reason of his death. The case of Penn. Mutual Life Insurance Company v. Lederer, 252 U. S. 523, relied on by petitioner, was a case involving the tax liability of the insurance company and not of the insured and while the language of that opinion indicates that the Court thought a savings bank and a life insurance company were somewhat analogous, it does not decide against the contentions of the respondent here. The insurance company is engaged in lending money, its income being primarily from interest but the

contract between the company and the policy holder is based on entirely different principles.

The point is made by petitioner that after May 19, 1908, the premiums having been fully paid the investment feature of the policies predominated and when the respondent in 1919, received the surrender value of the policies he collected his investment together with the profits thereon. This point is made on the reasoning of the Penn. Mutual case, but it is not applicable to this case.

The Court has judicial knowledge that whether the life insurance premium is payable in one lump sum or annually has nothing to do with the essential features of the contract as between the company and the insured. The company cannot expect any further sum from the insured, out of which to create a fund to pay the policies at maturity and of course its reserve additions to the particular policy must be created solely out of interest earnings or investments, savings on mortality or expense loadings. The respondent could have secured his protection by spreading his payments over a longer period, which would have added nothing to the essential features of the contract. The aggregate payments would have been more, but the interest earned less.

The Court also knows that the prevailing rate of interest on investments during the period of respondent's contracts was approximately four per cent.

If he had invested the $78,100.00 paid by him in premiums in securities yielding five per cent interest compounded annually he would have had returned to him on the maturity date of the policies $168,422.76

which would have been $47,625.76 more than he received out of the insurance. Assuming that the respondent was a man of reasonably good business acumen, we think this fairly shows that his purpose in effecting the insurance contract was to protect his estate against loss in the event of death and not for the purpose of investment.

Point III. Section 213 of the Revenue Act of 1918 does not Indicate that Congress Intended the Proceeds of Life Insurance Paid to the Insured to be Taxable Income.

Section 213 excludes from income the proceeds of life insurance paid to individual beneficiaries or to the estate of the insured.

Subsection 2 of that section also excludes return premiums received by the insured either during the term of the policy or at maturity. Under the subsection, if the Congress had intended to include the excess premium return as income, it could have so provided by the addition of a few words which it did not do. The very fact that the Congress wrote Section 213 and the subparagraphs in the language as appears is a strong indication that it did not intend the proceeds of insurance policies to be taxable under the Sixteenth Amendment, no matter by whom collected.

In writing every insurance policy it is essential that the company have some dependable information based on past experience to estimate the deaths likely to occur within the year in the group insured. This cannot be determined by the toss of a coin, the play of a card, the

roll of dice or the turn of a roulette wheel. It is likewise impossible to predict what particular individual will die within the year, but if the group is large enough and the ages known, we may determine with almost mathematical certainty how many will die within a given year. After this fact is ascertained the company must determine what sum will be required to meet the face of the policies at the expected maturity, which is always less than the face of the policies, because of the expected accretions by interest earnings, savings on mortality or expense loadings.

Because the company must guarantee the payment of the policy at maturity, the assumed interest rate is less than the prevailing rate, and if the deaths are less than expected and the interest earnings more than assumed, there is a saving in mortality. The savings in mortality do not constitute "income" as contemplated under the Sixteenth Amendment.

The Congress recognized the impossibility of separating the savings in mortality from interest earnings and expense loadings and for that reason sums received at the maturity of insurance policies, do not constitute taxable gain.

Funds saved from mortality experience in any year although available for surplus distribution do not constitute taxable income because such savings are not within the definition of income set out in the statute. All expense loadings not used during the year are also available for surplus distribution but these do not constitute taxable income.

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The legal reserve for petitioner's policies was four per cent. The company had available for surplus distribution excess interest earnings above the reserve rate. Dividends distributed from this source would be taxable if the interest was earned after March 1, 1913.

There was also available for surplus distribution sums derived from lapsed policies which had paid in premiums in excess of policy reserves and expense of writing. Funds from this source would not constitute taxable income. There was available for surplus distribution gain on the sale of capital assets if the company had such. Profit from this source would also constitute taxable income, if the gain was after March 1, 1913.

The method of determining surplus distribution to policyholders of the New York Life Insurance Company holding preferred dividend policies is stated in the case of Miller v. New York Life Insurance Company, 179 Ky. 246, 200 S. W. 484, in which the Court said:

> "The method of apportionment employed by the defendant when a class completes its period of accumulation, which method appears to have been followed in the case of plaintiff's policies, is: (1) To apply to each class, not the mortality experience of that class within itself, but the average mortality rate of the company's experience among all its deferred dividend policyholders; (2) to charge the policies of the class with their proportionate share of the company's expenses; (3) to credit the class with interest at the average rate earned by the company on all its funds; and (4) to apply the

average rate of lapse and surrender prevailing among all policies issued on that plan of insurance. Whenever a class completes its period of accumulation, the defendant company makes a calculation on the theory of its going into liquidation, and apportions to that class such part of the total assets of the company as it would receive if the company were on that date in fact going into liquidation. As to the particular class it is an actual liquidation. By this method, it is stated in the proof, all the assets of the company are apportioned, leaving no balance."

Point IV. Regulations of the Treasury Department do not have the Force and Effect of Law.

The petitioner relies on Article 72 B of Regulations 45 and Article 5 of Regulations 33, promulgated by the Treasury Department under the Revenue Acts of 1918 and 1917 respectively. Article 5 of Regulations 33 is a copy of the law. Article 72 B of Regulations 45 provides:

> "During his life only so much of the amount received by an insured under life endowment or annuity contracts as represents a return without interest of premiums paid by him therefor is excluded from his gross income."

A regulation promulgated by the Secretary of the Treasury cannot add to or take away a single word of the law or the Constitution nor can such a regulation be substituted for the law.

The income tax law has been in effect in the United States for comparatively few years and many questions

are now reaching the Courts for the first time. Most of the cases coming before the Bureau of Internal Revenue concerning life insurance have been those relating to dividends paid on policies and only three have been before the Department where a policyholder had gotten the policy before March 1, 1913, and had cashed it subsequently. For these reasons, the regulations issued by the Department should have but little weight.

The Commissioner of Internal Revenue cannot lift himself by his own boot straps. The writer had just as well cite his own opinion in support of his contentions as for the Internal Revenue Department to cite its own rulings in its support.

The Supreme Court in the case of Morrill, Collector, v. Jones, 106 U. S. 466, 3 A. F. T. R. 2448, in discussing the weight to be given Treasury regulations, said:

> "The Secretary of the Treasury cannot by his regulations alter or amend a revenue law, all he can do is to regulate the mode of proceeding to carry into effect what Congress has enacted."

In the case of the Grand Rapids and I. Railway Company v. Boyle, Collector, 245 Fed. 792, 1st A. F. T. R. 851, the Court said:

> "On the part of the defendant, there has been cited a Treasury decision. While that decision, which in fact is a rule promulgated for the guidance of revenue collectors of the government, is entitled to some consideration, it is not entitled to great weight, because to make it controlling would be permitting a party to a lawsuit to formu-

late and determine the rule of law by which his case should be decided. The party promulgating the rule contained in that Treasury decision is the real party defendant in this action, and, of course, courts cannot permit a party to a lawsuit to say what the rule of the law for the decision shall be."

See also the case of Greenport Basin & Construction Company v. United States, 269 Fed. Reporter, 58, 2nd A. F. T. R. 1289.

In the case of the United States v. Hurst, 2nd Fed. Rep. (2nd), page 73, 5th A. F. T. R. 5129, the Court said:

"Furthermore revenue statutes must be more strongly construed against the Government and in favor of the citizen in case of doubt. Gould v. Gould, 245 United States, 151."

Again, in the case of Baltzell v. Mitchell, 3rd Fed. Rep. (2nd) 428, 5 A. F. T. R. 5232, the Court said:

"The construction of a statute must be a rational and sensible one, having in mind its evident purpose and the intention of Congress, and if such a construction can be found it must prevail, even though in conflict with the dry words of the statute. Church of the Holy Trinity v. United States, 143 U. S. 457, 12 S. Ct. 511, 36 L. Ed. 226; United States v. Laws, 163 U. S. 258, 16 S. Ct. 998, 41 L. Ed. 151; Taylor v. United States, 207 U. S. 120, 28 S. Ct. 53, 52 L. Ed. 130."

In view of these cases the question here for decision must be approached with every presumption in favor of the taxpayer.

The petitioner relies on three decisions of the Board of Tax Appeals as sustaining his position that the sum received by the respondent in excess of the premiums paid constitutes taxable income.

First: Appeal of Armstrong, 1 B. T. A. 296.

Armstrong's policy was issued to him in 1901 and matured in 1920, and had certain tontine features. The Board decided that the March 1, 1913, value of the policy could not exceed the cash surrender value plus any accumulated dividend or excess premiums which had been credited to the policyholder in such a way he could have realized them had he surrendered the policy on March 1, 1913. The Armstrong policy had no provision postponing the payment of dividends or distribution of surplus. The only expression used in the Board's opinion which decides against the contention of the respondent is that the policyholder March 1, 1913, can take into consideration only those sums which he can obtain by surrender of the policy. The policy in this case had no maturity date, which depended on the withdrawal or death of the members of the group. We do not know what value the policyholder was claiming in excess of that allowed by the Board. In the opinion it is said:

> "The taxpayer has developed several involved theories of his taxability."

These theories are not disclosed. We find nothing in the opinion of value in deciding the instant case.

Second: Appeal of Kline, 3 B. T. A. 1138.

Kline had a policy in the New York Life Insurance Company which seems to be similar to those of the re-

spondent. All the premiums were paid prior to March 1, 1913. The terms of the policies are not set out. The Board states the facts and sustains the Commissioner on finding the March 1, 1913, value of the policy to be its cash surrender value. No opinion is written by the Board.

Third: Shamansky v. Commissioner, 8 B. T. A. 1276.

The only contention made by the taxpayer in the above case was whether the sum received in excess of premiums paid on an endowment policy was subject to surtax and normal tax or surtax only. Nothing was involved in the case similar to this one.

Point V. The Insurance Policies Surrendered by the Respondent in 1919 had a Value March 1, 1913, Greatly in Excess of the Premiums Paid.

On May 19, 1899, the respondent made application to the New York Life Insurance Company for the two insurance policies surrendered by him on May 19, 1919. The premium on each policy was to be paid in ten annual installments of $3,905.00, the total on both policies for all years being $78,100.00, all of which was paid before March 19, 1908. The Commissioner of Internal Revenue in determining the tax liability of the respondent found a gain in this transaction of $42,697.00, the difference between the premiums paid and the sum received on surrender and that all of this gain was realized by the respondent between March 1, 1913, and May 19, 1919. In other words the Commissioner found

on identically the same investment no gain for fourteen years and a gain of 35% plus in six years.

This conclusion is contrary to all principles of insurance financing and the gain as determined by the Commissioner shows his method of determining the profit was arbitrary and without sound basis.

It is a matter of common knowledge that insurance companies build up reserve to pay the face of policies at maturity and this is done by taking the premiums, when paid, and investing the sum at such a rate of interest as will accumulate a sufficient sum at the end of the expected life of the insured to pay the policy. At the time the respondent acquired his policies, Sections 88C, 69C, page 1969, Laws of New York, 1892, provided as follows:

> "Whenever any policy of life insurance issued after January 1st, 1880, by any domestic life insurance corporation, after being in force three full years, shall by its terms lapse or become forfeited for the non-payment of any premium or any note given for a premium or loan made in cash on such policy or security, or of any interest on such note or loan, the reserve on such policy computed according to the American Experience Table of Mortality at the rate of four and one-half per cent per annum shall, on demand made, with surrender of the policy within six months after such lapse or forfeiture, be taken as a single premium of life insurance at the published rates of the corporation at the time the policy was issued, and shall be applied, as shall have been agreed in the application or policy, either to continue the insurance of the policy

in force at its full amount, so long as such single premium will purchase temporary insurance for that amount, at the age of the insured at the time of lapse or forfeiture, or to purchase upon the same life at the same age paidup insurance, payable at the same time and under the same conditions, except as to payment of premiums as the original policy. If no such agreement be expressed in the application or policy, such single premium may be applied in either of the modes above specified at the option of the owner of the policy, notice of such option to be contained in the demand hereinbefore required to be made to prevent the forfeiture of the policy. The reserve hereinbefore specified shall include dividend additions calculated at the date of the failure to make any of the payments above described according to the American Experience Table of Mortality with interest at the rate of four and one-half per cent per annum, after deducting any indebtedness of the insured, on account of any annual or semi-annual or quarterly premium then due, and any loan made in cash on such policy, evidence of which is acknowledged by the insured in writing. The net value of the insurance given for such single premium under this section, computed by the standard of this State, shall in no case be less than two-thirds of the entire reserve, computed according to the rule prescribed in this section after deducting the indebtedness as specified, but such insurance shall not participate in the profits of the corporation. If the reserve upon any endowment policy, applied according to the provisions of this section as a single premium of temporary insurance be more than sufficient to continue the insurance to the end of the endowment

term named in the policy, and if the insured survive that term, the excess shall be paid in cash at the end of such term, on the conditions on which the original policy was issued. This section will not apply in any case where the provisions of the section are specifically waived in the application, and notice of such waiver is written or printed in red ink on the margin of the face of the policy when issued."

It will be noted under the above section that the reserve interest rate used in the State of New York was 4½%, compounded annually. It is also a matter of common knowledge that insurance companies fix the premium on the policy for a greater sum than will be needed at 4½%, compounded annually, to pay the policy at maturity. This is called "expense loading," which is used for the purpose of paying extraordinary claims arising from epidemics, pestilences, etc., also to pay what is usually called "overhead," such as office rents, officers' salaries, etc. Every life insurance policyholder carries his own insurance. If at any given age he should study the life tables and get his own expectancy and on that date invest a given sum of money yielding him 4½% compounded annually over a period of his expected life, then if he should live out his expectancy he would, at the end of his life, have accumulated a greater fund than that provided to be paid by a life insurance company, because he would save overhead expenses, the cost of writing the insurance which must be paid by all life insurance companies. No stock company could ever have enough capital to bear the weight

of the liability represented by the face of policies. It is as impossible for companies to dissipate their reserves in dividends to stockholders and survive as for a human to extend his life beyond the God-given span.

Even a superficial study of the subject is bound to convince anyone that the premium paid must be kept intact and have added to it each year interest compounded annually at at least 4½% to take care of the policy at maturity. The respondent paid his first premium of $7,810.00 on May 19, 1899. All of this sum was probably consumed in the expense of writing the insurance, made up of agent's commission, medical examination and other expenses incident thereto. All of the premiums were paid by May 19, 1908, and long before that time a part of this sum commenced to yield 4½% compounded annually. According to Mr. Bowerman, Actuary for the Company (R., p. 56), the two policies had a maturity reserve of $114,000.00 March 1, 1913. In addition to the policy reserve requirements, it is generally known that the interest yield was in excess of 4% or 4½% for all years prior to March 1, 1913. The insurance company had this source of income in excess of the policy reserve. It is also well known that expenses and losses incident to the operation of an insurance company cannot be known in advance and the premium is usually fixed at a greater sum to cover these contingencies than past experience would indicate as necessary. Excess interest earnings, savings in mortality and savings in expenses create what is usually referred to as the surplus earnings of an insurance company.

If it is a stock company, this surplus is available for distribution as dividends; if a mutual company, as is the New York Life Insurance Company, the sum is available for distribution to the policyholders.

Commencing as early as 1860 there was a widespread agitation in some of the eastern States for an investigation of insurance companies as to the methods of handling surplus earnings created from lapsed policies, excess interest earnings, savings in mortality and expense loadings. Up to that time and for a considerable period thereafter the funds contributed by the financially weak who were compelled to lapse their insurance went to the financially strong which resulted in large sums being distributed to those who had in no way contributed to produce them. These investigations, and exposures growing out of them, finally caused the enactment of laws in Massachusetts and New York providing against the forfeiture of funds paid to purchase life insurance. Other States, along with Kentucky, rapidly followed the lead of the eastern States so that by 1899 practically every State in the Union required insurance companies, in the case of lapsing policies, to use the reserves created to provide the insured with a paid-up insurance. Many of the States, including the State of New York, have adopted so-called annual "dividend statutes" requiring the yearly distribution of surplus among policyholders contributing to it. These provisions of the law are also found in the Kentucky Statutes, Sections 652 and 659. The Kentucky law is also made applicable to foreign insurance com-

panies doing business in the State. See Mutual Benefit Life Insurance Company v. O'Brien, 116 S. W. 750.

The Statutory law, of course, is a part of every insurance contract and under this law the respondent had set aside to him the reserve which his premiums bought and surplus earnings or policy dividends. It could not be taken from him under any contingency. These accretions were as constant and fixed as statutory enactment could make them.

In the case of Simons v. New York Life Insurance Company, *supra*, the Court in discussing the surplus provisions of a policy similar to respondent's said:

> "So far as that contract of insurance is concerned there is no claim that the defendant has not fully complied with its undertaking. One part of every premium is set aside to accumulate as a fund toward the payment of the policy when it becomes a claim against the company. That fund is called the reserve fund. Another part of the premium is consumed in paying the costs of insurance and expenses. The remaining third part, augmented by the excess of interest earned upon the reserve of the policy, is surplus. Under an ordinary policy this surplus is annually returned to a policyholder in some way agreed on and is commonly called dividend.
>
> "On this policy has been engrafted the system called tontine, under which that surplus, instead of being divided and paid to the policyholder, goes to a fund called the tontine fund, the amount being credited to the particular class to which the policy

belongs. When a policy lapses the reserve value becomes profits, and under the scheme such profits are divided among the surviving holders of the various classes. Such in substance is the tontine scheme, and such it was represented to be by the pamphlet issued by the company and read in evidence on the trial of this action. *The annexation of the plan to the policy did not invade nor vary the legal effect of that instrument as a policy of insurance for life* (Italics ours). It merely constituted a consent for the retention of the surplus dividend by the company during the tontine period, at the termination of which the accumulations from all sources are to be divided among the surviving holders of policies of that class in existence. The representations complained of had reference only to the surplus dividends, left with the company by consent of the insured for accumulation during the tontine period."

Point VI. The Provisions of the Policies.

The policies of the respondent were not separable into distinct contracts and in valuing them March 1, 1913, we must consider each in its entirety. In addition to the provisions of the policies providing for the payment of fixed sums in case of death, each had accumulation guarantees (R., pp. 22-23). The first was the right to participate in the surplus of the Company during the entire life of the policies, the first allocation to be made May 19, 1919.

The second provision set out how the accumulations were to be distributed, in one of four ways at the option

of the assured. Under the first option, he could receive a life annuity of $4,000.00, his age at that time being forty-four years with a life expectancy of 25.71 years which would have made a total paid in annuities of $102,840.00 and in addition to this he could convert the accumulated dividends into a life annuity.

Under the second option he could receive the dividends in cash and an annuity of $4,000.00 for life.

Under the third option, he could receive a guaranteed life annuity of $6,948.00 which based on his life expectancy would make a total paid in annuities of $179,833.08.

Under the fourth option, he could receive the entire face of each policy plus accumulated dividends in cash which he did.

If he elected to accept none of the above accumulation benefits he was entitled to a paid-up life insurance policy of $114,000.00.

Point VII. Facts Indicating March 1, 1913 Value.

If on March 1, 1913, the respondent had sought to value his policies he could not have determined the valuation by resorting to any market, because from the nature of the contract, it could not be traded in, bought or sold. The method usually employed to determine the fair cash value of any other assets was absolutely barred. The only method that could have been employed was to ascertain what the New York Life Insurance Company had that would probably be available for distribution to him on the maturity date of the poli-

cies. According to the terms of the contract he was to receive $100,000.00 in cash and whatever cash dividends were available for distribution. According to the records of the Company the policies had earned no dividends the first two years. The third year $450.00 was earned and there was a rapid increase down to January 1, 1913, when earnings amounted to $12,500.00 (R., p. 52). The history of the Company clearly indicated that the earnings subsequent to 1913 would be greater than prior thereto. According to the books of the Company the respondent could reasonably have concluded that he would receive on the maturity date of his policies $118,269.24. The Company had thirteen years experience in dividend accretions to the policies and had averaged annually $961.54. The earnings showed a constant increase and he could reasonably have anticipated that they would be greater for the years subsequent to March, 1913, than prior. In view of the fact that life insurance can have no market value, we must resort to some other method of valuation. In such state of case its value to the owner is one way to test it. See McCarthy v. Blacknell, 162 S. W. 1163; also its intrinsic value may be considered. See Virginia v. West Virginia, 238 U. S. 202; Henry v. North American Railroad Construction Company, 158 Fed. 79; Crutchfield v. Julia, 147 Fed. 65. What a person uniformly earned from a newspaper route was held to be competent evidence in the case of Aeken v. Spreckles, 24 Cal. A. 251. On the question of the value of rose bushes, plaintiff was permitted to testify as to the number of roses raised

per bush and the value per blossom. Southwestern Portland Cement Company v. Kezer, 174 S. W. 661.

In Section 202 of the Revenue Act of 1918 is used the following language:

"fair market price or value."

These words are not interchangeable and where there is no fair market price March 1, 1913, we must of necessity resort to the fair value of the assets and in line with the authorities above cited we must find what was the fair value of the insurance policies to the plaintiff March 1, 1913. From his standpoint he had the right to value them from every angle. They were undoubtedly worth more than the premiums he had paid thereon. He had paid the full premium several years before that time and reserves had been built up, which would carry the insurance far beyond March 1, 1913. The policies provided for the payment of $109,600.00 on that date in case of death and $114,300.00 if death occurred in 1919. At the time of maturity he could convert them into a much larger sum with fully paid-up insurance for life. The experience of the company showed the expectations of much greater dividend earnings. Their intrinsic value to him was at least the face of the policies $100,000.00 plus surplus additions of $12,500.00 which would make a total value March 1, 1913 of $112,500.00 and would show a taxable gain of $8,297.00.

Judge Mack, in the Appellate Court's opinion, criticizes this statement as follows:

> "The attempt is made, by reasoning not entirely clear, to take the face of the policy plus the provisionally apportioned dividends as the value in 1913. If the theory of this is that plaintiff was sure to get at least that amount in 1919, there is the obvious objection that plaintiff has lost sight of the fact that a future accruing sum must be discounted to find its present value" (R., p. 74).

Judge Mack overlooked the certainty of future savings from March 1, 1913, to the date of the maturity of the policies, which would be sufficient to offset the discount used to find present worth.

Valuation is always a question of fact and does not yield to arbitrary calculations or to fixed rules of arithmetic. When considered in connection with the income tax law it should be fair and just to both the Government and taxpayer and no fact or circumstance should be overlooked which throws any light on the subject. To say, as was said by the Commissioner of Internal Revenue, that the plaintiff realized a profit on this transaction of $42,697.00 is simply ignoring the truth and violates every intendment of justice.

In the case of Doyle v. Mitchell Bros. Company, 247 U. S. 179, the Court was discussing gain realized from the sale of assets acquired before and sold subsequent to 1913, and in discussing this point said:

> "The formula that the entire receipts derived from a conversion of capital assets after deducting cost value must be treated as net income, so far as it is applied to a conversion of assets acquired before the act took effect, and so as to tax as income

any increased value that accrued before that date, finds no support in either the letter or the spirit of the act, and brings the former into incongruity with the latter. If the gross receipts upon such a conversion are to be treated as gross income, what authority have we for deducting either the cost or the previous market value of the assets converted in order to arrive at net income? The deductions specifically authorized are only such as expenses of maintenance and operation of the business and property, rentals, uncompensated losses, depreciation, interest and taxes. There is no express provision that even allows the merchant to deduct the cost of the goods he sells.

"Yet it is plain, we think, that by the true intent and meaning of the act the entire proceeds of a mere conversion of capital assets were not to be treated as income. Whatever difficulty there may be about a precise and scientific definition of 'income' it imports, as used here something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax: conveying rather the idea of gain or increase arising from corporate activities. As was said in Stratton Independence v. Howbert, 231 U. S. 399, 415, 58 L. Ed. 285, 292, 34 Sup. Ct. Rep. 136. 'Income may be defined as the gain derived from capital, from labor, or from both combined.'

"Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the 'gross income' received 'from all

> sources' and by applying to this the authorized deductions we arrive at 'net income.' In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.
>
> "This has been recognized from the beginning by the administrative officers of the Government."

It will be noted in the above case that the court is thoroughly committed to the doctrine that there can be no taxable gain from the sale of capital assets or their conversion into cash until after the passage of the income tax law.

In the case of Lynch v. Turrish, reported in 247 U. S. 219, Turrish acquired in 1903 certain stock in a domestic corporation and in 1914 it sold its capital assets and distributed the proceeds to its stockholders. The corporation was the owner of large tracts of timber land, which had greatly increased in value due to a gradual rise in the market value of timber. Turrish received in the distribution twice the par value of his stock. The Commissioner of Internal Revenue assessed and collected taxes on all that Turrish received above par value on the ground that all the income had accrued to him after the income tax law became effective. The court, in deciding against the contention of the Commissioner, said:

> "The point in the case seems a short one. It, however, has provoked much discussion on not only the legal, but the economic distinction between

capital and income and by what processes and at what point of time the former produces or becomes the latter. And this in resolution of a statute which concerns the activities of men, and intended, it might be supposed, to be without perplexities and readily solvable by the offhand conceptions of those to whom it was addressed.

"The provisions of the act, so far as material to be noticed are the following: That there is assessed 'upon the entire net income arising or accruing from all sources in the preceding calendar year to every person residing in the United States, a tax of one per centum per annum upon such income.' • • •

"By paragraph B it is provided that, subject to certain exemptions and deductions, 'the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service, also from interest, rent, dividends, securities or the transaction of any lawful business carried on for gain or profit or gains or profits and income derived from any source whatever.'

"After specifying the exemptions and deductions allowed, the law declares as follows:

> 'The said tax shall be computed upon the remainder of said net income of each person subject thereto, accruing during each preceding calendar year ending December thirty-first; Provided, however, that for the year ending December thirty-first, nineteen hundred and thirteen, said tax shall be computed on the net income accruing from March first to December thirty-first, nineteen hundred and thirteen, both dates inclusive.'

"It will be observed, therefore, that the statute levies a normal tax and an additional tax upon net incomes, derived from whatever source, 'arising or accruing' each preceding calendar year ending December 31, 1913, the tax shall be computed on the net income accruing from March 1, 1913, to December 31, 1913.

"And in determining the application of the statute, to Turrish, we must keep in mind that, on the admitted facts the distribution received by him from the Payette Company manifestly was a single and final dividend in liquidation of the entire assets and business of the company, a return to him of the value of his stock upon the surrender of his entire interest in the company, and at a price that represented its intrinsic value at and before March 1, 1913, when the act took effect.

"The district court and the circuit court of appeals decided that the amount so distributed to Turrish was not income within the meaning of the statute, basing the decision on two propositions, as expressed in the opinion of the circuit court of appeals, by Sanborn, Circuit Judge: (a) The amount was the realization of an investment made some years before, representing its gradual increase during those years, and which reached its height before the effective date of the law, that is, before March 1, 1913, and the mere change of form of the property 'as from real to personal property, or from stock to cash,' was not income to its holders because the value of the property was the same after as before the change; (b) the timber lands were the property, capital, and capital assets of their legal and equitable owner, and the enhancement of their value during a series of years prior

to the effective date of an income tax law, although divided or distributed by dividend or otherwise subsequent to that date does not become income, gains, or profits taxable under such an act.'

"For proposition (a) the court cited Collector v. Hubbard (Brainard v. Hubbard), 12 Wall. 1, 20 L. Ed. 272; Bailey v. New York, C. & H. R. R. Co., 22 Wall. 604, 22 L. Ed. 840, and the same case in 106 U. S. 109, 27 L. Ed. 81, 1 Sup. Ct. Rep. 62. For proposition "B" Gray v. Darlington, 15 Wall. 63 L. Ed. 45, was relied on.

"The government opposes both contentions by an elaborate argument containing definitions of capital and income drawn from legal and economic sources and given breadth to cover a number of other cases submitted with this. The argument, in effect, makes any increase of value of property income, emerging as such and taxable at the moment of realization by sale or some act of separation, as by dividend declared or by distribution, as in the instant case. * * *

"In Collector v. Hubbard, *supra*, the distinction between a corporation and its stockholders was recognized, and that the stockholder had no title for certain purposes to the earnings of the corporation, net or other, prior to a dividend being declared, but they might become capital by investment in permanent improvements and thereby increase the market value of the shares, 'whether held by the original subscribers or by assignees.' In other words, it was held that the investments of the corporation were the investments of the stockholders; that is, the stockholders could have an interest, taxable under the act considered, though not identical with the corporation. This was repeated in

Bailey v. New York, C. & H. R. R. Company, 22 Wall. 604, 635, 636, 22 L. Ed. 840, 848, 849.

"The latter case came here again in 106 U. S. 109, 27 L. Ed. 81, 1 Sup. Ct. Rep. 62, and it was then declared that the purpose of an income tax law was to tax the income for the year that it accrued; in other words, no tax in contemplation of the law accrues upon something except for the year in which that something, earnings, profits, gains, or income accrues. In that case the subject of the tax was a scrip dividend, but the certificates did not show the year of the earnings and testimony as to the particular year was admitted. The principle applies to the case at bar. If increase in value of the lands was income, it had its particular time, and such time must have been within the time of the law to be subject to the law; that is, it must have been after March 1, 1913, but, according to the fact admitted, there was no increase after that date, and therefore no increase subject to the law. There was continuity of value, not gain or increase. In the first proposition of the court of appeals we therefore concur." • • •

There was no fresh contribution by the respondent after 1909 to the capital of his investment on which the Commissioner assessed the gain. The sole question for the Court to decide is what was the actual increase in plaintiff's investment from March 1, 1913, to May 19, 1919, and without any new contribution to the capital thereof it would seem there could be no gain.

Our courts, in an effort to arrive at justice in the administration of the law, so far as value is concerned, have in some cases applied the straight-line theory of

appreciation from cost to sale price. This principle has been applied in the valuation of corporate stock when there was no provable market value. Such an apportionment must rest on some fair inference of fact. This method of valuation peculiarly appeals to our reason in determining the gain realized by the respondent in the surrender of his insurance policies.

The Court judicially knows the tremendous improvement in health conditions in the United States from the beginning of the present century. Progress in sanitation and advancement in medical science have lengthened the average span of human life.

There has been no material change in interest earnings and it may be safely assumed that the greatest source of dividend distribution to policyholders of insurance companies is by reason of reduced mortality. The available sums for distribution to policyholders in mutual insurance companies has been gradual over the life of the policies.

It is fair both to the Government and the insured to spread the deferred dividends over the period of apportionment. In the case of United States v. B. M. C. Copper and Silver Mining Co., 1 Fed. (2d) 31, 5 A. F. T. R. 5070, the Commissioner of Internal Revenue had applied the "straight line" theory of increase on the sale of the capital assets of a corporation. The Court held it did not apply in that case but stated when it would apply as follows:

> "Were evidence of actual value wholly impossible, warrant for the application of the rule might

be found in necessity. So, too, it might be that from slight or remote evidence, such as that during a period of years there was a gradual and apparently uniform development of surrounding conditions bearing upon the value of specific property, which physically remained unchanged, the difference between the selling price at the end of the period and the cost at the beginning could reasonably be distributed over the entire period, without specific evidence of value in any given year. But such apportionment would rest upon a fair inference of fact, while the rule here put forth by the government is of universal application, without any proofs whatsoever, or any justification in necessity, and rests upon a pure presumption. I am inclined to think the case is not appropriate for the recognition of such a presumption.

"For present purposes, however, let us accept the theory upon which the government has proceeded. Admittedly the presumption is rebuttable, and makes only a *prima facie* case, the ultimate strength of which depends upon the nature of the property and attendant conditions. To find for it any basis of reason at all we must assume that in common experience the rise and fall in value of property is generally gradual and approximately uniform, and is graphically represented by a straight line, and that fluctuations, represented by a curved or broken line, are exceptional. We are to bear in mind, too, that the ultimate inquiry here is not the average increase in value per year during the period from 1887 to 1910, but the actual increase from January 1, 1909, to April 1, 1910, and that this actual increase is the only legitimate basis upon which the tax can be assessed. Doyle v. Mitch-

ell Bros., 247 U. S. 179, 38 Sup. Ct. 467, 62 L. Ed. 1054; U. S. v. Cleveland, etc., 247 U. S. 195, 38 Sup. Ct. 472, 62 L. Ed. 1064. Hence if we accept the straight line method, it must be regarded as the means, of reaching, not a general average for the entire period, but the actual increase during the period in question."

Point VIII. The Insurance Policies are Kentucky Contracts.

The applications for these policies ~~was~~ were written in Kentucky; sent to the home office in New York, the policies written at the home office and mailed to the agent and delivered by him to the respondent in Woodford County, Kentucky (R., pp. 58-59). The Court of Appeals of Kentucky, in the case of Jefferson v. the New York Life Insurance Company, 151 Ky. 609, 152 S. W. 780, in deciding what law would govern the provisions of the policy of the New York Life Insurance Company made and delivered under the same facts as in the case at bar, said:

"When his first statement is read in connection with his amplified statement, it is apparent that the policy was forwarded by the home office to the agent at Lexington, under the rules and regulations governing them in the conduct of their business, and these rules required, as stated, that the agent was to deliver the policy only under specified conditions, and not otherwise. So that the question as to whether or not the policy should be delivered by the local agent could be determined only

when the attempted delivery was made. If there was then no material change in the health of the applicant, and the requirements of the company as to payment of the first premium complied with, he was authorized to deliver the policy, and not otherwise. Under these circumstances, the policy was not forwarded by the home office to the local agent to be delivered by him without conditions or limitation. It was a Kentucky contract; and the New York statutes, having no extraterritorial force or effect, cannot be considered in determining appellants' rights. These rights must be determined by the contract of insurance as expressed in the policy when read in the light of the Kentucky statutes."

In the case of Maddox v. Mutual Life Insurance Company, 193 Ky. 38, 234 S. W. 951, the Court of Appeals described an insurance policy similar to respondent's as follows:

"Dividend policies are of different classes; some of them allow, by agreement, a distribution of the dividend annually, and they are called annual dividend policies; while others defer the right to appropriate the dividend or surplus to an agreed period, some 5 years, some 10 years, some 15 years, and others 20 years, as was agreed in the policy sued on herein, and they are called 'deferred dividend policies.' In deferred dividend policies it is usually stipulated that the insured is not entitled to any part of the surplus, or dividend, until the expiration of his dividend period, whatever that may be, and if he dies, and his policy should be paid within that time, the accumulated surplus or divi-

> dends accumulated on his policy is lost, and goes to augment the dividend fund to be applied to other policies of that class, which survive the dividend period. The same result is sometimes true with reference to lapsed or surrendered policies, but that source of augmentation of the surplus has been largely curtailed in latter years by statutory provisions for paid-up insurance."

In the above decisions the Kentucky Court recognized the validity of contracts providing for the distribution of so-called surplus of insurance companies to policyholders, but refused to permit their application in advance of date of maturity of the policy to the purchase of paid-up insurance.

The petitioner relies upon the cases of the New York Life Insurance Company v. Miller and Jefferson v. New York Life Insurance Company, heretofore cited by us. The only question decided by these two cases was that provisionally ascertained dividends could not be applied to purchase paid-up insurance when the policies lapsed before maturity. We are not concerned with accrual of either income or deductions. The primary question is one of valuation which is essentially different from when income is received or when deductions may be taken.

Adam Smith in his "Wealth of Nations" assigns to the word "value" two different meanings, one expressing utility of some object and the other the power of purchasing goods which the possession of a particular object enables the possessor to do. One may be called the "value in use," the other the "value in exchange." The value in use is undoubtedly very valuable evidence

as to the market value or intrinsic worth. Any person purchasing property is chiefly concerned as to return in money or use. The best evidence of value of the insurance policies of the respondent as of March 1, 1913, was not what he could realize from them on that date, but what they would return to him in the future. In the case of Wells Fargo Company's Express v. Crawford County, 63 Ark. 576, 37 L. R. A. 374, the Court said in discussing the value of property:

> "The value of the property results from the use to which it is put and varies with the profitableness of that use present and prospective actual and anticipated."

Point IX. Cost is not Synonymous with Market Value.

The Commissioner arbitrarily used cost as to the value of the insurance policies March 1, 1913. The premiums were fully paid on the policies by May 19, 1908, almost five years before March 1, 1913. As we understand the rule, cost is no evidence of value independent of other and supporting evidence. This is especially true where the property has been acquired remotely from the time of valuation. See Schoet v. Oriental Storage Company, 155 Wisconsin, 121.

Point X. Forfeited Value of the Insurance Policies March 1, 1913, is no Evidence of Fair Value.

The petitioner contends that the March 1, 1913, value of respondent's policies was their loan value plus the then accumulated dividends and in support of his contention quotes from the testimony of Mr. Bowerman, Assistant Actuary of the New York Life Insurance Company, who testified (R., p. 55) that the respondent could have borrowed on his policies on March 1, 1913, $74,600.00, and if the loan had not been paid the policies would have lapsed to the company and the respondent woud have forfeited his dividends.

If respondent had borrowed the maximum loan value of his policies, to wit, $74,600.00, at five per cent (R., p. 16), the interest thereon to maturity would have been approximately $22,380.00, which would have left $3,020.00 plus accumulated dividends at maturity. These were continuing contracts and sums received on forfeiture at any date are no fair evidence of value. He would have incurred forfeiture penalties if he had surrendered the policies on any date before maturity. These facts demonstrate the illogical and senseless method the defendant uses to determine March 1, 1913, value.

Point XI. Criticism of Method used by Lower Court in Determining March 1, 1913 Value.

Judge Dawson determined the March 1, 1913, value of the policies in the following manner as stated in his opinion:

> "Under all the circumstances, I think it is fair to both the Government and the plaintiff to fix the value of what the plaintiff could at that date have reasonably anticipated they would have been worth on the 19th of May, 1919, under the fourth option heretofore referred to, arriving at the then present value by the application of a four per cent interest rate, compounded annually. As I have heretofore indicated, I think the plaintiff on March 1, 1913, could reasonably have anticipated that at the end of the accumulation period he would receive at least $19,428.57 of accumulations, and in addition thereto the face value of the policies, or a total of $119,428.57. The present value of this sum on March 1, 1913, at four per cent interest compounded annually would be $93,587.81. This amount, I think, should be treated as the fair value of the plaintiff's two policy contracts on March 1, 1913. Deducting this sum from $120,797.00, the amount actually received by the plaintiff upon the surrender of his policies at the accumulation period, would result in a taxable gain of $27,209.19. Of this sum $20,797 was paid out of earned surplus, and is therefore taxable as dividends, which $6,412.19 thereof would be subject to both normal and surtax" (R., P. 28).

We think the error committed by the lower court lies in the fact that he discounted the anticipated income from the policies four per cent from date of maturity to March 1, 1913. This was undoubtedly on the assumption that from March 1, 1913, to date of maturity there would be no further accumulated dividends to be allocated to these policies. Based on the previous experience of the Company as testified to by Mr. Bowerman (R., p. 50), it could reasonably be anticipated that the earnings subsequent to March 1, 1913, would be greater than those prior to March 1, 1913. If the respondent could have sold his contract to a purchaser who was willing but not compelled to buy, such a purchaser could reasonably have anticipated that future accumulations would more than offset four per cent interest on the purchase price and would not have discounted the sum expected to be realized.

Point XII. Fair Method of Valuation.

On March 1, 1913, the respondent knew he would get, if living on May 19, 1919, $100,000.00 in cash and he also knew that there was already an ascertained surplus of $13,600.00 on the two policies with a reasonable expectation of the surplus increasing before maturity. We think the fair value of the two policies was $113,600.00, which, deducted from the sum received on surrender, to wit, $120,797.00, leaves a profit of $7,197.00, which is the entire sum, if any, that should be taxed.

The policyholders in a mutual life insurance company have the same status as a stockholder in a corpo-

ration. In valuing the stock of a corporation probable future earnings are an important factor, which is equally true in valuing an insurance policy. Chicago Railway Equipment Company v. Blair, 20 Fed. (2d), 10; United States v. Guggenheim Exploration Company, 238 Fed. 231.

CONCLUSION.

Respondent respectfully contends—

First. That the sums received by the respondent on the surrender of the insurance policies did not constitute income as provided in the Sixteenth Amendment.

Second. Using total premiums paid as the March 1, 1913, value of these policies is arbitrary and no proof of correct value.

Third. That the sums respondent would have received on the forfeiture of the policies March 1, 1913, are no evidence of March 1, 1913, value.

Fourth. That the face value of the policies plus provisionally ascertained dividends is the best evidence of March 1, 1913, value, if any.

ELWOOD HAMILTON,
Attorney for Respondent.

GEORGE V. TRIPLETT,
BECKHAM, HAMILTON & BECKHAM,
Of Counsel.